

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of        )  
WELCO WOOD PRODUCTS, INC.        )

For Appellant:   James A. Steele  
                          Public Accountant

For Respondent: James W. Hamilton  
                          Acting Chief Counsel

Steven S. Bronson  
Counsel

OPINION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Welco Wood Products, Inc. , against proposed assessments of additional franchise tax in the amounts of \$3,427.72, \$3,599.86, and \$3,149.65 for the taxable years ended September 30, 1972, September 30, 1973, and September 30, 1974, respectively. Subsequent to the filing of this appeal,

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appellant paid the proposed assessments in full. Accordingly, pursuant to section 26078 of the Revenue and Taxation Code, this appeal is treated as an appeal from the denial of claims for refund.

The sole issue presented for determination is whether certain payments made by appellant to its three officer-shareholders during the income years 1972 and 1973 are deductible as reasonable compensation pursuant to section 24343 of the Revenue and Taxation Code.

Appellant, Welco Wood Products, Inc., was incorporated in California on December 1, 1971. Its present business is the outgrowth of a sole proprietorship which was owned by Leslie E. Welsh (hereinafter referred to as Welsh). Welsh and two principal employees, Frank Sperry and Henry Faustino (hereinafter referred to as Sperry and Faustino), successfully operated the sole proprietorship for several years prior to the formation of appellant.

During the income years in issue, in addition to constituting appellant's board of directors, Welsh, Sperry, and Faustino held the corporate offices of president, vice president, and secretary -treasurer, respectively. The three men were also appellant's only shareholders: Welsh owned 60 percent of appellant's stock, and Sperry and Faustino each owned 20 percent.

For each of the income years in issue, appellant paid Welsh, Sperry, and Faustino annual salaries which totaled \$60,000. Pursuant to a prior agreement, the three officer-shareholders also received quarterly distributions of appellant's current earnings in the total amounts of \$40,000 and \$43,000 for the income years 1972 and 1973, respectively. The quarterly payments were distributed in exact proportion to each recipient's respective stock interest in appellant.

On its California franchise tax returns for the income years in issue, appellant deducted the amounts paid to its officer-shareholders, including the quarterly distributions, as reasonable compensation. Respondent disallowed, as in excess of reasonable compensation, the portion of appellant's deductions which represented the quarterly distributions. Appellant protested the proposed deficiencies resulting from the disallowances, and this appeal followed.

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Section 24343 of the Revenue and Taxation Code provides, in pertinent part:

(a) There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the income year in carrying on any trade or business, including --

(1) A reasonable allowance for salaries or other compensation for personal services actually rendered... ..

Appellant contends that the total payments made to its three officer-shareholders for the years in question constituted reasonable compensation for services actually rendered, and were deductible as ordinary and necessary business expenses under section 24343. Respondent contends that the total alleged compensation, to the extent of the quarterly distributions, was unreasonable in amount and, that the quarterly distributions actually constituted nondeductible dividend payments to the shareholders.

Whether compensation is reasonable for tax deduction purposes is a question of fact which must be decided on the basis of a review of all the facts in each particular case. (See Irby Construction Co. v. United States, 290 F. 2d 824; Heil Beauty Supplies v. Commissioner, 199 F. 2d 193; Appeal of Southland Publishing Co., Inc., Cal. St. Bd. of Equal., Jan. 7, 1964.) Factors which various courts have considered relevant to their inquiry as to the reasonableness of compensation include the type and extent of services rendered by the employee, the prior earning capacity of the employee, general economic conditions of the period, the amounts paid by similar enterprises for services of a like character, and comparison of shareholder distributions with salary payments made to shareholder-employees. (See 4A Mertens, Law of Federal Income Taxation § 25.69; See also Irby Construction Co. v. United States, supra, 290 F. 2d at 826. )

It is well established that the burden of proving the extent to which purported salary payments constitute reasonable compensation for services actually rendered rests upon the taxpayer. (Botany Worsted Mills v. United States, 278 U. S. 282, 289 [73 L. Ed. 379]; Northlich, Stolley, Inc. v. United States, 368 F. 2d 272, 277; Appeal of Southland Publishing Co., Inc., supra. ) The record on

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appeal is devoid of any evidence which might support appellant's assertion that the quarterly distributions to its three officer-shareholders for the years in question constituted reasonable compensation for services actually rendered. Appellant has not presented any specific information with respect to the type and extent of services rendered to the corporation by Welsh, Sperry, and Faustino, either in their capacities as officers or as employees. The only substantive evidence which appellant submitted on appeal is a chart which reveals that the annual salaries paid by appellant to Welsh, Sperry, and Faustino for the income years in question, without inclusion of the quarterly dividends, are substantially less than the annual salaries received by them as employees of the sole proprietorship. However, without some evidence as to the, actual value of the services rendered by Welsh, Sperry, and Faustino to appellant during the years in question, the salary comparison is meaningless. There is no evidence in the record to indicate error in respondent's conclusion that the regular annual salaries paid to the officer-shareholders were adequate compensation for the services rendered. Therefore, we must conclude that appellant has not carried its burden of proving that the quarterly dividend payments constituted reasonable compensation for services actually rendered.

Furthermore, there is ample evidence in the record to support **respondent's conclusion that the quarterly distributions** in question constituted nondeductible dividend payments to the corporate shareholders. The quarterly distributions were paid out of appellant's current earnings and in exact proportion to each recipient's respective stock interest in the corporation. The record also indicates that, as of September 30, 1973, appellant had neither declared nor paid dividends to its shareholders in any amount since its formation in 1971. Finally, appellant treated the distributions as dividend payments on its federal income tax returns for the years in question. When considered together, these factors strongly suggest that the quarterly distributions were, in reality dividend payments thinly disguised as compensation in an attempt to avoid payment of taxes. (See Charles McCandless Tile Service v. United States, 422 F. 2d 1336, 3339; Northlich, Stolley, Inc. v. United States, supra, 368 F. 2d at 278; R. J. Reynolds Tobacco Co. v. United States, 149 F. Supp. 889, 895, cert. denied, 355 U. S. 893 [21 L. Ed. 2d 191]; Robert Sanders, et al. , T. C. Memo., March 29, 1973; Nor-Cal Adjusters, T. C. Memo., Aug. 16, 1971, aff'd, 503 F. 2d 359. )

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Therefore, in accordance with the views expressed above, we conclude that respondent's action in this matter must be sustained.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Welco Wood Products, Inc., for refund of franchise tax in the amounts of \$3,427.72, \$3,599.86, and \$3,149.65 for the taxable years ended September 30, 1972, September 30, 1973, and September 30, 1974, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 4th day of May, 1976, by the State Board of Equalization.

*William G. Spence* Chairman  
*George E. Spence* , Member  
*Robert H. Spence* , Member  
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\_\_\_\_\_, Member

ATTEST:

*W. W. Sump* Executive Secretary